Japan Shows How to Defuse the Debt Time-bomb

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Global Research, May 29, 2011
webofdebt.com 29 May 2011

Region: Asia
Theme: Global Economy

[T]hreatening to default should not be a partisan issue. In view of all the hazards it entails, one wonders why any responsible person would even flirt with the idea. – Alan S. Blinder, Princeton professor of economics, former vice chairman of the Federal Reserve

A game of Russian roulette is being played with the national debt ceiling. Fire the wrong chamber of the gun, and the result could be the second Great Depression.

The first Great Depression led to totalitarian dictatorships, war to consolidate power, and concentrations of capital in the hands of a financial elite. The trigger was a default on the global reserve currency, in that case the pound sterling. The U.S. dollar is now the global reserve currency. The concern is that default could create the same sort of global panic today. Dark visions are evoked of the President declaring a national emergency, FEMA plans locking into place, camps being readied for protesters, and the secret government taking over . . . .

This *may* all just be political theater, but do we really want to get close enough to the economic precipice to find out? The conservative ideologues toying with the debt ceiling are doing it to force cuts in the budget, a budget that was already approved by Congress. Congress is being held hostage by a radical minority pushing a risky agenda, one that is based on an economic model that is obsolete.

High-stakes Gambling

On May 16, the Wall Street Journal published an opinion piece titled "The Armaggedon Lobby," which claimed that a "technical default" on the federal debt was just "political melodrama" and not really a big deal:

[B]ond markets can figure out the difference between a genuine default when a country can't pay its bills and a technical default of a few days if it serves the purpose of fixing America's fiscal mess.

Not so, said Saudi Prince Alwaleed bin Talal in a May 20 interview on CNBC. "That's gambling. This is the United States. You're leading the whole world. You cannot play games with that."

It is not just that the government could be brought to a standstill, with a third of its bills now being paid by borrowing; or that interest rates would shoot up, forcing thousands of homeowners into foreclosure. Failure to pay on the national debt could trigger a default on the global reserve currency. As one commentator described what could go wrong:

[T]he consequences of a US default could spark yet another global financial crisis. The US could lose its triple-A rating, which could cause a sell-off in Treasury notes by institutional and foreign investors. This sell-off could lead to higher interest rates, and banks' balance sheets might be decimated by the decline in their bond portfolios. Thus, global banking and financial market liquidity could dry up. Lending between institutions and people or businesses could possibly cease altogether or become cost prohibitive.

A Rerun of 1931?

The sort of chaos that could ensue was seen when Great Britain reneged on its deal to redeem pound sterling banknotes in gold in 1931. The result was the worst global depression in history.

When the pound went off the gold standard, markets panicked. People rushed to exchange their paper money for gold, in any currencies in which that was still possible. The gold wound up hidden under mattresses and in safety deposit boxes, unspent; and the banks from which it was pulled, having no reserves to back their loans, quit lending or closed their doors. Credit froze; business ground to a halt.

As other countries ran short of gold, they too were forced to take their currencies off the gold standard. The last holdouts suffered the most, including the United States, which kept its gold window open until 1933.

The 19th century had been plagued by bank runs, caused by banks having too little gold to back their outstanding loans. The Federal Reserve was instituted in 1913 ostensibly to prevent those runs, but its levee did not hold back the run of the 1930s. In 1933, the country suffered a massive banking collapse, forcing President Roosevelt to declare a banking holiday and take the U.S. dollar, too, off the gold standard.

Freed from the Bankers' "Cross of Gold"

The transition off the gold standard was a painful one; but according to Beardsley Ruml, Chairman of the Federal Reserve Bank of New York, the country was the better for it. In a paper read before the American Bar Association in 1946, he said that going off the gold standard had finally allowed the country to be economically sovereign:

Final freedom from the domestic money market exists for every sovereign national state where there exists an institution which functions in the manner of a modern central bank, and whose currency is not convertible into gold or into some other commodity.

Freed from the strictures of gold, Roosevelt was able to jump-start the economy with deficit spending. As Marshall Auerback details, the next four years constituted the biggest cyclical boom in U.S. economic history. Real GDP grew at a 12% rate and nominal GDP grew at a 14% rate.

Then in 1937, Roosevelt listened to the deficit hawks of his day and slashed the deficit. The result was a surge in unemployment, and the economy slipped back into depression.

What lifted the country out of the doldrums was again deficit spending, liberally engaged in to fund World War II. In wartime, few people worry about the national debt. The debt grew to 120% of GDP – twice what it is today — and wound up sustaining another very productive period in U.S. history, one that set the country up to lead the world in manufacturing for the next half century.

On Inflation and Taxes

Ruml said federal taxes were no longer needed to fund the budget, which could be financed by issuing bonds. The principal purpose of taxes, he said, was "the maintenance of a dollar which has stable purchasing power over the years. Sometimes this purpose is stated as 'the avoidance of inflation.'"

The government could spend as needed to meet its budget, drawing on credit issued by its own central bank. It could do this until price inflation indicated a weakened purchasing power of the currency. Then, and only then, would the money supply need to be contracted with taxes.

"The dollars the government spends become purchasing power in the hands of the people who have received them," Ruml said. "The dollars the government takes by taxes cannot be spent by the people," so the money supply can be contracted with taxes as needed.

When the economy is in a recession, however – as it is now — the government needs to spend in order to get purchasing power into the hands of the people. Businesses cannot hire more workers until they have more customers demanding their products, and the customers won't come until they have money to spend. The money ("demand") must come *first*. Adding money will not drive up prices until the economy is at full employment. Before that, increasing "demand" will drive up "supply" by setting the engines of production in motion. When supply and demand rise together, prices remain stable.

We now know that a government can go quite far into debt without a dangerous level of price inflation occurring – much farther than the U.S. has gone today. Besides World War II, when U.S. debt was 120% of GDP, there is the remarkable example of Japan. Japan has retained its status as the world's third largest economy, although it has a debt to GDP ratio of 226% — and it is still fighting *deflation*.

Critics of the deflationary theory point to commodity prices, which are soaring today. But if those prices were due to the economy being awash with "too much money chasing too few goods," real estate prices would be soaring too. Instead, the real estate market has collapsed. What has actually happened is that the housing bubble has transmuted into the commodity bubble, as "hot money" has fled from one to the other. The overall money supply is still in decline.

The deficit hawks have been predicting for years that the federal debt would sink the dollar and the economy, and it hasn't happened yet. In fact the federal debt has not been paid off since 1835, and no disaster has resulted. The debt has not only been carried on the government's books but has continued to grow, and the economy has grown and flourished along with it.

This is not an economic anomaly. The economy has flourished *because* of the national debt. Nothing backs the currency today but "the full faith and credit of the United States." Money is no longer a metal; it is an inflow and outflow, credits and debits. The liabilities of the government are the assets of the private economy. The national debt is what backs the money supply.

Dealing with the Rising Cost of Debt Service

There *is* a potential time bomb in a growing federal debt, but it is one that can be defused. The debt has risen from $10 trillion to $14 trillion just since the banking crisis of 2008, not from "entitlements" but due to the Wall Street collapse and bailout. Just the interest on this growing debt could cripple the tax base if interest rates were at normal levels, so they have had to be pushed almost to zero. The result has been to create a dollar carry trade. This has facilitated speculation in commodities, a major cause of today's commodity bubbles.

There is, however, a solution to this problem, and it was discovered by Japan. The government can spend, not by issuing bonds at interest to the public, but simply by creating an overdraft at the central bank, as Beardsley Ruml recommended. The Bank of Japan now holds an amount of public debt equal to the country's GDP! As noted by the Center for Economic and Policy Research:

Interest on [Japanese] debt held by the central bank is refunded back to the treasury, leaving no net cost to the government on this debt. . . . Japan continues to experience deflation, in spite of the fact that its central bank holds an amount of debt that is roughly equal to its GDP. This would be equivalent to the Fed holding $15 trillion in debt.

Like the Bank of Japan, the Federal Reserve now returns the interest it receives to the government. With a rising interest tab on the federal debt no longer a problem, private interest rates could be allowed to rise to normal levels.

Today the Fed is not permitted to buy bonds directly from the Treasury but must go through middleman bond dealers. But that problem too could be fixed. In a supporting statement in 1947, Federal Reserve Chairman Marriner Eccles discussed a bill to eliminate the unnecessary cost of these middlemen. He said the Federal Reserve had been allowed to purchase securities directly from the government from its inception in 1914 until the Banking Act of 1935. Then:

A provision was inserted in that act requiring all purchases of government securities by Federal Reserve banks to be made in the open market, which means purchased chiefly from dealers in Government bonds. Those who inserted this proviso were motivated by the mistaken theory that it would help to prevent deficit financing. . . .

Nothing constructive would be accomplished by the proviso that the Reserve System must purchase Government securities exclusively in the open market. About all such a ban means is that in making such purchases a commission has to be paid to Government bond dealers.

The interest cost and the bond dealers' cut could both be eliminated by allowing the Treasury to borrow directly from its own central bank, interest free.

Nothing to Fear But Fear Itself

We have been frightened into believing that government debt is a bad thing, but nearly all money today originates as debt. As Marriner Eccles observed in the 1930s, "That is what our money system is. If there were no debts in our money system, there wouldn't be any money."

The public debt is the people's money, and today the people are coming up short. Shrinking the public debt means shrinking more than just the services the government is expected to provide. It means shrinking the money supply itself, along with the ability to provide the jobs, wages and purchasing power necessary for a thriving economy.

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